Peralta Community College District, California; General Obligation

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Rationale

Standard & Poor’s Ratings Services assigned its ‘A+’ long-term rating to Peralta Community College District, Calif.'s 2011 taxable refunding bonds. At the same time, Standard & Poor’s affirmed its ‘AA-’ long-term rating on the district’s general obligation (GO) and ‘A+’ long-term rating on the district’s pension obligation bonds outstanding. The outlook on all ratings is negative.

The rating reflects our view of the district’s:

- Strong underlying local economy situated in Alameda County, with full participation in the greater San Francisco Bay Area economy and strong income indicators;
- Continued demand for the district’s educational services due in part to the recent economic downturn; and
- Maintenance of a good financial position during the past three fiscal years.

Offsetting these foregoing strengths, in our view, are cuts in state funding that have prompted the district to reduce expenditures through cuts in services and staffing levels.

Unlimited ad valorem taxes levied on taxable property within the district secure the outstanding GO bonds. The Alameda County Board of Supervisors has the power and obligation to levy these taxes at the request of the district for the bonds’ repayment. The county is required to deposit such taxes, when collected, into the bonds’ debt service fund. The OPEB bonds and the 2011 refunding bonds are secured by any available sources of the district’s general fund revenues, based on the district’s absolute and unconditional obligation to make debt service payments. The 2011 bonds will be used to refinance the district’s 2009 taxable pension obligation refunding bonds.

Located in Alameda County, the district encompasses roughly 78 square miles, including the cities of Alameda, Albany, Oakland, Berkeley, Emeryville, and Piedmont. Incomes levels for the district’s residents are very strong in our view: The median household effective buying income is 130% of the national level, which, in our opinion, is due in part to the district’s participation in the strong and diverse regional Bay Area economy. Similarly, the district’s assessed value (AV) has experienced what we consider strong growth over the past five fiscal years, rising at an average annual rate of 4.5% from 2007 to 2011. However, AV experienced a modest decline in our view, 2%, in fiscal 2012, which management attributes to a weakened housing market. Regardless, the district’s AV remains extremely strong, totaling roughly $110,000 per capita in fiscal 2012.
Demand for the district’s educational services remains strong, in our opinion, given the recent economic downturn; the district has historically kept enrollment at or above the state-funded cap. In fiscal 2010, the district maintained enrollment at 22,160 full time equivalent students (FTES), which is 3,150 FTES above the state-funded cap. This fiscal year represented the highest unfunded FTES the district has maintained during the past five fiscal years. As a result, management began to limit enrollment and reduce the amount of unfunded FTES with a goal of maintaining total enrollment just slightly above the funded cap. In fiscal 2011, the district was successful in reducing total enrollment levels by roughly 2,200 FTES with an ending enrollment of 19,926 students, which is just 425 FTES above the funded cap. For fiscal 2012, management aims to lower the amount of unfunded FTEs even more, with a total enrollment target of 18,500 FTES and just 211 unfunded FTES. The enrollment cap on state funding has decreased in fiscal 2012 primarily due to the difficulties with the state budget.

The district’s financial position has remained strong during the past three fiscal years, we believe in part due to continued demand for the district’s educational services, which tends to run countercyclical to the economy. However, due to the state’s funding cuts during the past two fiscal years, the district’s unrestricted general fund has been reduced in part to address the current shortfall in state funding. Based on audited fiscal 2010 results, the district ended with reserves of roughly $8.2 million or 6.2% of unrestricted general fund expenditures, which is roughly $2.2 million less than the prior fiscal year. In response to the cuts in state funding, the district has cut spending in recent years through furloughs, staff reductions, and reductions in business and student service and travel expenditures. Overall, based on estimated actuals for fiscal 2011, the district expects reserves to end at $6.4 million or 4.6% of total general fund expenditures (restricted and unrestricted). For fiscal 2012, management has already implemented $2 million in spending cuts primarily by reducing the number of classes as well as by reducing part-time staff. We understand the state may cut funding by $1.7 million, which represents a worst-case scenario projected by the district. In response, the district is considering further reductions in part-time staff for fiscal 2012. Overall, reserves are expected to remain above the district’s reserve requirement of 5% of unrestricted general fund expenditures.

The district’s management practices are considered "good" under Standard & Poor’s Financial Management Assessment (FMA) methodology. An FMA of "good" indicates our view that practices exist in most areas although not all may be formalized or regularly monitored by governance officials.

In the beginning of fiscal 2011, the district was placed on probationary status for its accreditation by the Accrediting Commission for Community and Junior Colleges (ACCJC), which we understand was based on concerns about the district’s financial status, technology-related problems, and governance issues. As of fiscal 2012, the ACCJC removed the district from probation status, reflecting the ACCJC’s view of the district’s improved fiscal management and financial reporting practices. We understand there are three levels the ACCJC uses before complete removal of accreditation status: warning, probation, and show-cause, with show-cause being the last step before removal. Although the district remains on warning status with the ACCJC, we understand management expects its warning status will be eliminated with the ACCJC’s final review in March 2012. Should the district lose its accreditation, we believe it would face significant losses in enrollment levels and negative rating actions may be possible.

The district’s overall net debt burden is high, in our view, at roughly $5,200 per capita or 4.6% of market value. The district participates in the State of California Teachers Retirement System as well as the California Public Employees Retirement System. The district made its full annual required contribution (ARC) in fiscal 2011, which totaled roughly $6.2 million. The district also contributed $8.2 million, or roughly 64% of its total ARC, for its other post-employment benefit (OPEB) obligations in fiscal 2011. Management indicates they generally budget to
pay for a majority of its OPEB contribution from the general fund and pays for the rest of its OPEB contribution from its revocable OPEB trust fund, which is estimated by management to contain roughly $164 million as of June 30, 2011.

**Outlook**

The negative outlook reflects our view of the district’s current warning accreditation status although we understand the district has improved its accreditation status in the past fiscal year. In addition, the negative outlook reflects our view of a difficult budgeting climate going forward, partly due to rising pension obligation costs and state funding cuts that we believe are likely to occur in the near term. The district will likely need to continue to reduce its spending going forward to maintain balanced operations in our view. Negative rating actions may be possible if the district’s reserves fall below what we consider to be adequate levels.

**Debt Derivative Profile: ’2.5’**

Peralta Community College District has six forward interest rate swap agreements outstanding in relation to its taxable 2005 limited-obligation OPEB bonds series B-1, B-2, B-3, B-4, B-5, and B-6. Standard & Poor’s has assigned the district a debt derivative profile (DDP) score of ’2.5’ on a scale of ’1’ to ’4’, with ’1’ representing the lowest risk. The DDP score of 2.5 represents low to moderate risk, in our view, and is based on the following:

- The swap portfolio’s above-average economic viability over stressful economic cycles, which reduces basis risk;
- The absence of formal written policies governing the use of interest rate swaps;
- Moderate counterparty risk due to what we consider to be the credit strength of the district’s counterparty, Morgan Stanley, although termination events occur when counterparty ratings fall below ’BBB-’; and
- Low termination risk.

The swaps are floating-to-fixed interest rate swaps with Morgan Stanley Capital Services (rated A/Negative/A-1 based on a guarantee by Morgan Stanley), and the fair market value of all swaps combined is roughly negative $10.3 million as of June 30, 2010. The swap hedges, or swaps to fixed rate, the bonds as they convert to a variable rate (auction rate).

The terms of the swap agreement follow the same accretion schedule as that of the corresponding underlying bonds. Provisions of the agreement provide the district with the option to terminate at market cost of the swap. Both parties must terminate if either of their respective ratings fall below ’BBB-’. Collateral postings are not required by the district. Postings are required from Morgan Stanley to the district if swap valuations exceed the relevant threshold; the only posting that the district would be subject to would be to return any collateral that the counterparty had previously posted, which has not thus far occurred.

We understand the district intends to terminate the series B-1 swap in conjunction with the 2011 bond issuance, which currently has a termination value of roughly $2.97 million. We understand the district will use available funds kept in their OPEB reserve fund, which is kept separate from the general fund. Based on the district’s 2010 audit, the district had roughly $14 million in its OPEB reserve fund.
Related Criteria And Research

- USPF Criteria: GO Debt, Oct. 12, 2006
- USPF Criteria: Debt Derivative Profile Scores, March 27, 2006

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